United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLANT

ORIGINAL

76-7031

United States Court of Appeals For the Second Circuit

B
P/S

THE BOHACK CORPORATION,
Plaintiff-Appellant,

-against-

ALISON MORTGAGE INVESTMENT TRUST,
Defendant-Appellee.

On Appeal From The United States District Court For The Eastern District Of New York

Appellant's Brief

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UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

In the Matter of
THE BOHACK CORPORATION,

Debtor.

THE BOHACK CORPORATION,

Plaintiff-Appellant,

-against-

ALISON MORTGAGE INVESTMENT TRUST,

Defendant-Appellee

APPELLANT'S BRIEF

PRELIMINARY STATEMENT

Plaintiff-Appellant in this action (hereinafter plaintiff) appeals from an order of the Eastern District of New York (Weinstein, J.) entered on December 16, 1975, dismissing the complaint herein for lack of subject matter jurisdiction, i.e., failure of diversity. The District Court held that a Real Estate Investment Trust (hereafter REIT) is an unincorporated association which may be sued in each state in which its investors reside, and since, presumptively, there were investors residing in New York when this action was filed, no diversity existed.

ISSUES PRESENTED AND SUMMARY OF ARGUMENT

We shall argue in this brief that a REIT is a single legal entity, separate and apart from its members for the purposes of diversity jurisdiction. We shall further argue that for all aspects of business life other than Tax purposes, a REIT is a de jure and de facto corporation. The issue thus presented is whether a REIT, organized for tax benefits, may use its special status, conferred upon it by Congress for a limited purpose, to avoid recourse by others to the Federal Courts in diversity cases.

POINT I

A BUSINESS TRUST IS A CORPORATION FOR THE PURPOSES OF DIVERSITY JURISDICTION

A business trust is created wherever several persons transfer the legal title in property to trustees with complete power of management in such trustees, free from the control of the creators of the trust, and the trustees in their discretion pay over the profits of the enterprise to the creators of the trust, or their successors in interest. Under the common law, such a trust is created by the act of the parties and does not depend upon statutory law for its validity. *Goldwater v. Oltman*, 210 Cal. 408, 292 P. 624 (1930).

In the case of *Hecht v. Malley*, 265 U.S. 144, 44 S. Ct. 462, 68 L. Ed. 949 (1923), Mr. Justice Sanford commented on such organizations by stating:

> "The Massachusetts Trust is a form of business organization, common in that State, consisting

essentially of an arrangement whereby property is conveyed to trustees, in accordance with the terms of an instrument of trust, to be held and managed for the benefit of such persons as may from time to time be the holders of transferable certificates issued by the trustees showing the shares into which the beneficial interest in the property is divided. These certificates, which resemble certificates for shares of stock in a corporation and are issued and transferred in like manner, entitle the holders to share rateably in the income of the property and, upon termination of the trust, in the proceeds."

"Under the Massachusetts decisions these trust instruments are held to create either pure trusts or partnerships, according to the way in which the trustees are to conduct the affairs committed to their charge. If they are the principals and are free from the control of the certificate holders in the management of the property, a trust is created; but if the certificate holders are associated together in the control of the property as principals and the trustees are merely their managing agents, a partnership relation between the certificate holders is created". Id., 265 U.S. at 146.

The Court concluded by stating:

"We think the word 'association' as used in the [Revenue] Act includes 'Massachusetts Trusts' such as herein involved, having quasi-corporate organizations under which they are engaged in carrying on business enterprises." Id., 265 U.S. at 157.

Article A of Alison's Declaration of Trust states:

"A. 2 Nature of Trust. This trust is a business trust for purposes of real estate investment organized under the laws of California". *Mercer Affidavit*, at 1.

When a New York court is confronted with the character of a Massachusetts (business) trust, it can utilize its choice of law rules under *Erie v. Tompkins*, 304 U.S. 64 (1938) and refer the resolution of this matter to the law of the situs fo the trust.

> "Defendant is a Massachusetts trust. It was organized in the state under a written declaration of trust. The character of this business organization, at least when it is made a defendant, is to be determined by law of Massachusetts and not by the General Association Law of this State. (*Matter of Associated Trust* [D.C.] 222 F. 1012). Any other holding would put our claimants at a disadvantage against one suing in Massachusetts in personam. The Massachusetts statute (Gen. Laws Mass. [Ter. ed.] chp. 182 §6) provides that such an association may be sued and its property may be subject to an attachment in like manner as if it were a corporation, and service of process upon one of the trustees shall be sufficient. *** *Plaintiff has rightfully treated a defendant as if it were virtually a foreign corporation, and not an unincorporated association,* which under our domestic law must be sued in the name of its president and treasurer". *Textile Properties, Inc. v. M.J. Whitall Associates, Ltd.*, 157 Misc. 109, 282 N.Y.S. 25 (1934). (emphasis added).

This proposition, that the business trust is virtually a corporation, was upheld by the First Circuit to sustain diversity jurisdiction in the case of *Bomeisler v. M. Jacobson & Sons Trust*, 118 F.2d 261 (1st Cir., 1941), cert. den. 364 U.S. 630, 62 S. Ct. 61, 86 L.Ed. 505. The Court said:

> "It may well be that in such trusts the trust instrument should be construed strictly in order to

> afford maximum protection to the beneficiaries. But these rules, evolved to govern the traditional type of trusts, cannot be carried over and applied without change in the field of business trusts of the type here presented. The defendant trust was created, not to conserve an estate or guarantee a steady income to certain beneficiaries, but to aggregate the capital contributions of the six associates for the purpose of conducting an extensive and complex business which ordinarily would be carried on by a partnership or a corporation. It can scarcely run with the hares and hunt with the hounds by disclaiming the corporate analogy when this becomes inconvenient. The defendant's powers are of course limited to those conferred by its deed of trust; but *we think this instrument should be considered as analogous to a corporate charter and as broadly interpreted*." Id., at 265 (emphasis added).

In the same vein, New York statutes indicate that the business trust is to be treated as a corporation. §359-m, of the *General Business Law* states:

> In this Article, unless the context otherwise requires:
>
> (c) '*corporation*' *means a private or public corporation, association or trust issuing a security.*"

Other relevant New York statutes are §209 of the *Tax Law*, which states that a "real estate investment trust" for Federal purposes is subject to the New York corporation franchise tax. See C.C.H. *New York Tax Reports* Paragraph 5-119a, and Section 181 of the *Tax Law*, making a REIT subject to the same licensing fee as a foreign corporation.

POINT II

A CALIFORNIA REAL ESTATE INVESTMENT TRUST IS A CORPORATION FOR THE PURPOSES OF DIVERSITY

The real estate investment trust was created by Congress to allow persons to invest in real estate without the tax burdens imposed on a corporation. "Although unincorporated it must be so organized that were it not for the provisions of the new [tax] law, it would be taxable as a corporation." *Public Ownership of Real Estate-Real Estate Trust Laws Provide Impetus, 9 U.C.L.A. Law R.* 570.; see *Internal Revenue Code,* 1954, as amended, §856 et seq.; Prentiss Hall, *Federal Regulations,* §1.856 et seq. (1973). The only reason why a real estate investment trust is not a corporation, is that Congress felt it could justify more easily this new entity's tax treatment if it were not taxed as a corporation. 9 *U.C.L.A. Law R.*, supra, at 570.

The state of California has specifically provided for the creation of a real estate investment trust. "A real estate investment trust or association which complies or intends to comply with Sections 856, 857 and 858 of the Federal Internal Revenue Code of 1954, as amended . . . "*West's Ann. Corp. Code,* §23000. In addition, before a real estate investment trust can function, it must secure a permit from the California Commissioner of Corporations. *West's Ann. Corp. Code* §23002.

Under California law, when two or more persons are associated in a business which they transact under a common name, the association is held to be a "separate entity", and an action against it is regarded as an action against a single defendant. *Potts v. Whitson,* 52 C.A.2d

199, 125 P.2d 947 (1942); see *West's Ann. Civil Code* §388. " . . . in California, the entity theory has been established by a number of decisions. *** Under this theory, the association is, for the purposes of the section [338] a legal entity distinct from its members." *Juneau Spruce Corp. v. International L. & W. Union*, 119 C.A.2d 144, 259 P. 2d 23 (1953).

The defendant contends that case law is clear that their organization, as an unincorporated association, is situated in every state where its stockholders reside. They rely basically on three cases for this proposition: *United Steel Workers v. Bouligny, Inc.*, 382 U.S. 145 (1965); *Baer v. United Services Automobile Association*, 503 F. 2d 393 (2nd Cir., 1974); and *Lawin Mortgage Investors v. Riverdrive Mall, Inc.*, 392 F. Supp. (S.D., Texas, 1975).

We think the law is not that clear. In *People of Puerto Rico v. Russell & Company*, 288 U.S. 476, 53 S.Ct. 447, 77 L.Ed. 903 (1933), a suit was commenced in an insular district court of Puerto Rico by the people of Puerto Rico in order to recover assessments levied on a realtor, Russell & Company. This company was organized under the laws of Puerto Rico as a sociedad en comadita, the civil law counterpart to a limited partnership. Under Section 41 of the Organic Act of Puerto Rico (48 U.S.C. 863), the action was instituted in the Federal District Court based on the premises that since all the members of the sociedad were nonresidents of Puerto Rico, there was diversity of citizenship.

The Supreme Court held that there was no diversity of citizenship, deciding that the sociedad was a citizen of Puerto Rico. The basis of this conclusion was that under Puerto Rico civil law, the sociedad was "consistently regarded as a judicial person". 53 S.Ct. at 449. Speaking

for the Court, Mr. Justice Stone remarked that the legal personality of the sociedad:

> " . . . *is so complete* in contemplation of the law of Puerto Rico that we see no adequate reason for holding that the sociedad has a different status for purposes of federal jurisdiction than a corporation organized under that law. In neither case may non-residents of Puerto Rico, who have taken advantage of its laws to organize on business there, remove from the insular courts controversaries arising under local law." 53 S. Ct. at 449".

In *Mason v. American Express Company*, 334 F.2d 392 (2d Cir., 1964), The Second Circuit adopted this interpretation of inquiry into citizenship for purposes of diversity jurisdiction. *Mason* involved a joint stock association organized under the laws of New York. The District Court dismissed the suit for lack of diversity. However, the Second Circuit reversed, stating:

> "It is our considered judgment that the Supreme Court has abandoned the artificial and mechanical rule of *Chapman v. Barney* in favor of a more flexible test for capacity for citizenship, a test which determines that consideration be given to whether an organization's essential characteristics sufficiently invest it, like a corporation, *with a complete legal personality distinct from that of the members it represents.*" Id., at 393 (emphasis added).

In arriving at this result, the Court pointed out that New York statutes endowed the joint stock association with attributes associated with a corporation. See *Hibbs v. Brown*, 190 N.Y. 167, 82 N.E. 1108 (1907); *Mason*, supra. They also indicated that the characteristics of a joint stock association and a sociedad as in *People of Puerto Rico* are identical.

Last, the Court expounded upon the equitable considerations to reach this result. One reason was the similarity between the corporation and the joint stock association, especially under New York law. The other reason was that due to the size of such organizations, if the Court was forced to follow Chapman, then the plaintiff would not be able to obtain access to a federal court because it could not obtain complete diversity of citizenship.

In *United Steel Workers of America v. Bouligny, Inc.*, supra, the Supreme Court held that an unincorporated labor union is a citizen of each state in which its members reside for the purposes of diversity.

Following that decision, the Second Circuit in *Baer v. United Services Automobile Association*, supra, limited its previous holding in *Mason* under the constraint of *Bouligny*. It phrased the issue posed by *Bouligny* as whether there is a distinction between a corporation and the entity involved under the law of the state of creation. It is respectfully submitted that for all purposes except that of taxation, a REIT is a corporation under the laws of the State of California, and, thus, is a corporation for diversity purposes.

Instructive in this regard is a law review article found in 9 *U.C.L.A. Law Rev.* at page 564, written shortly after the statutory enactment of provisions for real estate investment trusts in the State of California. That article makes very clear that the real estate investment trust was conceived by Congress to avoid corporate taxation only, and that the California statutory scheme is designed solely to achieve that result. We herewith quote several relevant portions of that article:

> "Actually, real estate investment trusts have existed for decades. Their spawning ground was

the State of Massachusetts, the laws of which so restricted the ownership of real estate by corporations that it became necessary to develop an alternative form of group ownership.

* * *

"Following the enactment of a federal corporate income tax, the use of the business trust form spread rapidly throughout the United States since it apparently provided a means for group ownership of real estate or a business without the imposition of the corporate income tax. (p. 565)

* * *

"It remained, therefore, the role of Congress not to create a legal entity, but to restore the status of the real estate investment trust as a conduit of income rather than as a taxable entity. (p. 565)

* * *

"In view of the fact that one of the requirements for avoiding the corporate income tax is that the trust have at least one hundred shareholders, the provisions of both the Federal Securities Act of 1933 and the California Corporate Securities Act will obviously be applicable. (p. 566)

"Insofar as it was possible, the requirements and conditions previously applicable to regulated investment companies were made applicable to the new real estate investment trusts. However, Congress has drawn a sharp line between passive investments and the active operation of a business, and has extended the regulated investment company type of tax treatment only to income from the passive investments of real estate investment trusts. It was clearly the intent of Congress that any real estate investment trust engaging in active business operations should continue to be subject to the corporate tax in the same manner as in the case of similar operations carried on by other comparable enterprises.

* * *

"PRESCRIBED ORGANIZATION. In order to initially qualify as a 'real estate investment trust,' an organization must be an unincorporated (p. 569) trust or association managed by trustees which issues transferable shares or certificates evidencing ownership. Although unincorporated it must be so organized that were it not for the provisions of the new law, it would be taxable as a corporation. In view of this requirement there would appear to be no sound reasons why the corporate entity could not be used to qualify for this favorable tax treatment — except that the law requires the entity to be an unincorporated trust or association. Apparently, Congress felt it could justify the new law more easily to critical constituents by pointing out that the entity which was granted freedom from the corporate tax wasn't actually a corporation. At least one perceptive Congressman has discerned the fact that the only ultimate effect of this requirement is to prevent the residents of some states from taking advantage of this legislation and causing a great deal of confusion and extra work for the residents of other states. (p. 570)

"The application for a permit to issue the securities of a real estate investment trust will follow very closely the application of any corporate entity for the same purpose. In addition to the information required by statute and existing regulations, there must be submitted copies of the following: the declaration of trust; by-laws; forms of share certificates; all agreements, if any, with trustees, depositaries, custodians, advisors, and underwriters; all proceedings by the trustees respecting the issuance of shares; an opinion of counsel that the trust will be able to comply with the Internal Revenue Code provisions, and that all of its outstanding shares will be validly issued; and

> all contracts for the management and operation of trust properties." (p. 592)

The California statutory scheme clearly establishes the virtual corporate nature of the real estate investment trust. Thus, Chapter 1976 of the Statutes of California, enacted at the 1961 regular session, establishes in §25153 of the Corporations Code that corporate subscriptions and interest in a real estate investment trust will be treated exactly alike. That act was deemed an urgency measure by virtue of the following facts included in the enabling legislation:

> "Congress enacted amendments to the Federal Internal Revenue Code of 1954 which became Sections 856, 857 and 858 and which became effective January 1, 1961. These sections provide certain tax benefits for real estate investment trusts. Real estate investment trusts are now being organized and their shares are being sold to the public. The protection of investors in such trusts requires that the provisions of this bill relating to the liabilities of investors in such trusts go into immediate effect."

Sections 23000 through 23003 are the only statutory references to real estate investment trusts as a new entity. The cases previously cited under California law establish clearly that for all purposes other than taking advantage of the provisions of the Internal Revenue Code, real estate investment trusts are treated as corporations in California.

Moreover, Alison's Articles of the Declaration of Trust clearly establish that the business of the trust is to be conducted like that of a traditional corporation, except for taxation purposes, by virtue of the special type of investment involved.

Without burdening the court with extensive quotations

from the Articles, we refer to the following sections as indicating that for all practical purposes, a real estate investment trust is a corporation: Art. B (A18-20); Art. C (A20-23); Art. G (A29-31); Art. H (A31-32).

The policy considerations underlying our agreement have been amply explored, both in previous decisions of this Court and in the Supreme Court of the United States. We suggest that the application of the federal diversity statute to a real estate investment trust is not an extension of federal jurisdiction, but rather a recognition of the reality of the business world. It should be noted that in creating the trust as a separate entity for Federal tax purposes, the legislation was entirely in terms of the Internal Revenue Code and not in terms of any other aspect of corporate life.

Section 17009 of the California Corporation Code specifically defines Massachusetts trusts and business trusts as corporations for the purposes of the Code. So does Section 23;38 of the California Bank and Corporation Tax Law.

In other areas, REITs have been treated the same as corporations even for venue purposes under various Federal laws. Thus, the Seventh Circuit Court of Appeals in *Matter of Bankers Trust*, 403 F.2d 16 (1968), held that for venue purposes a REIT should be venued in its principal place of business, and that business trusts should be treated generally as analagous to corporations. Under these circumstances, it would seem that there is no sound reason for denying diversity jurisdiction with respect to a REIT.

We have argued that allowing a REIT to be treated as a citizen of one state for purposes of diversity jurisdiction is not a judicial extension of Congressional intent with respect to jurisdiction. Rather, we maintain the exemption created for one purpose, i.e., taxation, should not be treated as an

exemption for all purposes under the various Federal laws. Thus, our reference to the treatment of REITs under the Bankruptcy Act is significant in this regard. This Court, in light of its holdings in *Mason* and *Baer*, should not feel constrained by *Bouligny* to hold that there is a lack of diversity. Rather, it should view the realities of the situation and hold that for diversity purposes a REIT stands in no different stead than a corporation.

CONCLUSION

THIS COURT SHOULD FIND THAT THE DISTRICT COURT HAS JURISDICTION OVER THIS ACTION AND REVERSE THE ORDER BELOW.

Respectfully submitted,

SHAW AND LEVINE
Attorneys for
Plaintiff-Appellant

Dated: March 17th, 1976

JESSE I. LEVINE, ESQ.
Of Counsel

SHAW AND LEVINE Bohack v. Alison Mortgage

STATE OF NEW YORK)
: SS.
COUNTY OF NEW YORK)

ROBERT BAILEY, being duly sworn, deposes and says, that deponent is not a party to the action, is over 18 years of age and resides at 286 Richmond Avenue, Staten Island, N.Y. 10302. That on the 17 day of March 1976 deponent served the within Brief upon:

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the address(es) designated by said attorney(s) for that purpose by depositing 3 true copies of same enclosed in a postpaid properly addressed wrapper, in an official depository under the exclusive care and custody of the United States post office department within the State of New York.

Robert Bailey

Sworn to before me, this 17
day of March, 1976.

William Bailey
WILLIAM BAILEY
Notary Public, State of New York
No. 43-0132945
Qualified in Richmond County
Commission Expires March 30, 1976